

WAYWARD BULLETS: MORE SMALL BUSINESS TAX CONCESSIONS

INTRODUCTION

With the advent of the global financial crisis this is clearly a challenging time for small business.¹ Whilst the former Coalition Government introduced a succession of small business incentives, as commentators² have noted these ‘benefits’ are some what problematical. In light of the recent Labor Government proposals for further small business incentives (the 20 per cent PAYG instalment reduction³ and the bonus depreciation deduction for businesses⁴) and the current review of Australian taxation,

¹ Australian Taxation Office, Draft National Tax Liaison Group minutes of the 26 November 2008 meeting [<http://www.ato.gov.au/taxprofessionals/content.asp?doc=/content/00176566.htm>], The Commissioner has observed an increase in losses, debt issues and a tightening for business.

² M Pizzacalla, ‘Problems and Priorities - Australia’s SME taxation system requires further change’ (2009) Thomson, 3 Weekly Tax Bulletin, 92; H Hodgson ‘Small business simplification – yet again?’ (2007) 11(2) *The Tax Specialist* 140, Samarkovski Freudenberg above n 11; J Tretola, ‘The Simplified Tax System- Has it Simplified Tax at all and if so Should it be Extended?’ (2007) published in the proceedings of the 19th Australasian Tax Teachers Association National Conference, Queensland, 22 January 2007; M McKerchar, ‘Is the Simplified Tax System Simple?’ (2007) 10 *The Tax Specialist* 140; M Burton, ‘The Australian Small Business Tax Concessions – Public Choice, Public Interest or Public Folly?’ (2006) 21 *Australian Tax Forum* 71; Taxation Institute: Submission to the Taskforce on Reducing the Regulatory Burden on Business 28 November 2005 www.regulationtaskforce.gov.au/submissions/sub078.rtf; Institute of Chartered Accountants: Submission to the Taskforce on Reducing the Regulatory Burden on Business 28 November 2005; G Shaw, ‘Changing to the Simplified Tax System’ (2005) *Taxpayers Australia* 7 November 2005, 154; G Walker, ‘The Simplified Tax System- the Good, the Bad and the Ugly’ (2003) 7, 20 *CCH Tax Week* 95; B Bondfield, ‘A Year on in the Simplified Tax System: has the reality matched the rhetoric?’ (2002) 37 *Taxation in Australia* 253; P Kenny, ‘Accounting Principles and Taxation Rules for Small Business: The Impact of Ralph’ (2005) 1 *Journal of Australasian Tax Teachers Association* 79; P Kenny ‘A Simplified Tax System for Small Business: Or, Just Another Tax Preference?’ (2002) 6 *The Tax Specialist* 36; B Bondfield, ‘If there is an Art to Taxation the Simplified Tax System is a Dark Art’ (2002) 17 *Australian Tax Forum* 313; M Hine, ‘Small Business Tax System (STS)’ Taxation Institute of Australia, Western Australian State Convention May 2001, 24; I Snook, ‘Simplified Tax System: A Favourable Current, a Riptide or Just Plain Dead Calm?’ Taxation Institute of Australia, South Australian State Convention May 2001, 75; L Wolfers and J Miller, ‘The Simplified Tax System: Is this Government Speak for “Complex”?’ (2001) 35 *Taxation in Australia* 374; F Martin, ‘STS Implications’ (2001) 36 *Taxation in Australia* 245; R Douglas, ‘Tax Simplification for Small to Medium Business’ (2000) Taxation Institute of Australia New South Wales State Convention May 2000, 8; G Cooper, ‘The Government Response to the Ralph Report: An Initial Overview’ (1999) 34 *Taxation in Australia* 232.

³ Prime Minister’s media release, ‘\$4.7 Billion Nation Building Package’, 12 December 2008 [http://www.pm.gov.au/media/Release/2008/media_release_0687.cfm]; and Treasurer’s media release Nos 140, ‘Reduction of the Quarterly Pay-As-You-Go Instalment Due in February 2009 for Small Businesses’ [<http://www.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2008/140.htm&pageID=003&min=wms&Year=&DocType=>].

⁴ Prime Minister’s media release *ibid*, Treasurer’s media release 141 ‘Investment Allowance to Boost Business Investment’ [<http://www.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2008/141.htm&pageID=003&min=wms&Year=&DocType=>], 12 December 2008; Joint media release by the PM, Treasurer and Minister for Small Business, ‘Small Business and General Business Tax Break’ 3 February 2009 [<http://www.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2009/012.htm&pageID=003&min=wms&Year=&DocType=>].

Australia's Future Tax System,⁵ (hereinafter known as the *Henry Review*), this paper examines the small business entity (SBE) tax concessions. This paper calls for a more targeted and simpler approach to the taxation of small business.

2 BACKGROUND: THE FORMER SIMPLIFIED TAX SYSTEM

The origins of the former small business tax concessions, the Simplified Tax System⁶ (STS), can be traced back to the *Review's* first paper where it correctly identified the general problem of onerous compliance costs for small businesses.⁷ Moreover, as the *Review*⁸ noted the costs of tax compliance for small business are highly regressive. However, the *Review*⁹ then inappropriately attributed this problem to the perceived difficulties that small businesses were having with the following four income tax accounting issues: the accruals income tax accounting rules,¹⁰ the prepayment framework,¹¹ the capital allowances regime¹² and the trading stock rules.¹³ Thus the *Review* recommended 'simplified' rules for small business for: a cash system of income tax accounting,¹⁴ treatment of prepaid expenses,¹⁵ capital allowances¹⁶ and trading stock.¹⁷ It is evident though that the alternative non – STS income tax accounting rules for accruals, prepayments, capital allowances and trading stock did not greatly burden small business since these measures are required for financial

⁵ *Australia's Future Tax System*, (Chaired by Dr Ken Henry), [http://taxreview.treasury.gov.au/content/Content.aspx?doc=html/review_panel.htm], known herein after as the *Henry Review*.

⁶ Former Div 328 *Income Tax Assessment Act* 1997 (ITAA 1997).

⁷ Review of Business Taxation, *A Strong Foundation Discussion Paper* (1998) (herein after called *A Strong Foundation*), 14-22; Review of Business Taxation, *A Tax System Redesigned, More Certain, Equitable and Durable, Report* (1999), 575. For example, in 1996 the Australian federal Government embarked on a campaign to help free Australia's then 860,000 small businesses from the constraints of crippling taxes and red tape with the establishment of the *Small Business Deregulation Taskforce*, C Bell (Chair) *Time for Business: Report of the Small Business Deregulation Task Force*, AGPS, Canberra, 1 November 1996. As the *SBD Taskforce* observed, tax loomed as the main regulatory compliance issue for small business. Notwithstanding the efforts of the *SBD Taskforce*, with the voluminous tax reforms flowing from the *Review's* 1999 report and the introduction of the goods and services tax on 1 July 2000, the taxation laws expanded from some 3,000 odd pages of legislation in 1996 to over 10,000 pages in 2007.

⁸ Ibid *A Tax System Redesigned*, 74. Also see: C Evans, K Ritchie, B Tran-Nam, M Walpole, *A report into taxpayer costs of compliance* (1997), 85. Smaller businesses have fewer resources to comply with tax legislation and thus their tax compliance costs expressed as a percentage of business revenue are far higher than larger businesses. Leading tax practitioner bodies have similarly argued that tax laws impose an intolerable burden on small business, see S Harrison, (CEO) Institute of Chartered Accountants in Australia, Open Letter to Tax Commissioner Carmody, 13 August 2002, <http://www.icaa.com.au/news/index.cf?menu=226&id=A105289876>; R Regan, (President: National Tax & Accountants Association) NTAA supports call for tax practitioners to revolt, National Tax & Accountants Association Press Release 15 August 2002; G Levy Tax Crisis – Hard Times Call for Hard Actions, Taxation Institute of Australia Press Release, 13 August 2002, <http://www.taxinstitute.com.au/cda/media/1,1316,1,00.html>

⁹ *A Tax System Redesigned* above n 7, 575.

¹⁰ ss 6-5, 8-1 ITAA 1997.

¹¹ s 82KZM *Income Tax Assessment Act* 1936 (ITAA 1936).

¹² Div 40 ITAA 1997.

¹³ Div 70.

¹⁴ Former subdiv 328-C.

¹⁵ s 82KZM ITAA 1936.

¹⁶ Subdiv 328-D ITAA 1997.

¹⁷ Subdiv 328-E.

accounting, managerial accounting and internal control purposes.¹⁸ These tax accounting provisions are long established and thus appear to be well understood by small business, taxation practitioners and administrators.

Notwithstanding the above concerns, in July 1999 the *Review* recommended that an optional STS be introduced for small businesses with annual turnover or annual receipts of less than \$1 million.¹⁹ Small businesses in the STS were subject to mandatory cash accounting, concessional prepayment expenditure and simplified accelerated depreciation regimes. The STS also provided a simplified trading stock regime but this was optional.²⁰ The *Review's* STS recommendations appear to have been the show case²¹ of its reforms for small business, being one of its largest tax expenditures²² that would help a vast number of taxpayers.²³

It is apparent that there were a number of weaknesses in the *Review's* STS design processes. First, the *Review* misdiagnosed the problem. The *Review* incorrectly attributed the high level of compliance costs for small business to the impact of the accruals income tax accounting rules,²⁴ the prepayment framework,²⁵ the capital allowances regime²⁶ and the trading stock rules.²⁷ These provisions appear to be very workable for small business, providing good synergies with financial accounting rules.²⁸

Additionally, the *Review* appears to have designed its STS concessions within a very short period of 6 months or less and without any community consultation. The STS concerned small business yet the *Review's* head committee solely consisted of corporate directors.²⁹ The absence of small business taxation law and policy experts would appear to have greatly restricted the ability of the head committee to design its STS effectively.³⁰ It further made the head committee overly reliant on assistance from the *Treasury Tax Reform Taskforce*.³¹ Given the influence of Treasury, the *Review* seemed preoccupied with maximising tax revenue as evident in the poor accessibility of the STS concessions, the complicated STS integrity rules and the minute STS trading stock exemption.

The *Review's* extremely broad terms of reference appeared to cover the entirety of a highly complex business income taxation system.³² Narrower terms of reference that sought to focus on parts of the business income tax system such as small business taxation would arguably have been more manageable and avoided many of the STS issues.

¹⁸ J Hoggett et al, *Financial Accounting*, (6th ed, 2006); AASB *Framework for the Preparation and the Presentation of Financial Statements*.

¹⁹ *A Tax System Redesigned* above n 7, 575.

²⁰ *Ibid*.

²¹ Bondfield above n 2, 314.

²² *A Tax System Redesigned* above n 7, 698, 721.

²³ *Ibid* 576, The *Review* referred to 1993 data from the Australian Bureau of Statistics that 95 per cent of businesses would be eligible to join the STS since their turnover was less than \$1 million. Given that the STS did not commence until 1 July 2001 this figure appears to be grossly inflated.

²⁴ ss 6-5, 8-1 ITAA 1997.

²⁵ s 82KZM ITAA 1936.

²⁶ Div 40 ITAA 1997.

²⁷ Div 70.

²⁸ Hoggett above n 18, 130; AASB Framework above n 18 paras 94, 95.

²⁹ *A Tax System Redesigned* above n 7, vii.

³⁰ Notwithstanding the presence of such experts on sub-committees to the *Review*.

³¹ *Ibid*.

³² *A Tax System Redesigned* above n 7, v-vii.

The *Review's* terms of reference were announced on 14 August 1998 and the extended reporting date was set at 30 July 1999, a period of eleven and one half months.³³ The tight timeline for the *Review's* research and consultation processes and the completion of the three papers and the report posed immense challenges in view of the complexity and scale of the recommendations.

Given that the STS concessions were primarily designed to simplify the income tax system for small business,³⁴ it is suggested that it would have been appropriate for the *Review* to refer firstly to the relevant tax research on how this may have been achieved, then consider the alternatives and go on to consult widely with the community, tax law experts, small business, professional and Government bodies.

It is submitted that the *Review* first needed to quantify the compliance burden for the various sizes of small business. By identifying what the problem is and who is affected the *Review* would have been in a sound position to design an appropriate policy response. Such compliance costs research would also have helped to determine an appropriate definition of small business.

Subsequent to the release of the *Review's* report in September 1999 the federal Government sought consultation on the *Review's* STS proposals by asking for submissions on its *Exposure Draft; Business Tax System (Simplified Tax System) Bill 2000*. However, consultation on this Bill was strictly limited.³⁵ Submissions criticising the design and complexity of the STS were provided to the federal Government.³⁶ For example, industry bodies pointed to its lack of commerciality and unsuccessfully requested a wider definition of small business (with higher annual turnover thresholds), simpler integrity measures for groups and inflexibility of the four elements of the STS concessions, rather than mandatory application.³⁷ These concerns were ignored.³⁸

Consequently, the federal Government generally agreed³⁹ with the *Review's* STS recommendations and these rules provided the basis for STS legislation contained in

³³ Ibid vii.

³⁴ Ibid 575.

³⁵ Bondfield above n 2, 359; Commonwealth Treasury National Tax Liaison Group meeting 7 December 2000,

<http://www.ato.gov.au/content.asp?doc=/content/Professionals/13389.htm&page=3#H6>, The National Tax Liaison Group meeting minutes noted that 'Treasury viewed the STS consultation as very close to 'ideal', but were concerned that professional bodies did not share this view.'

³⁶ Taxation Institute of Australia, Submission on the *Exposure Draft; Business Tax System (Simplified Tax System) Bill 2000*, 17 November 2000, 8.

³⁷ Bondfield above n 2, 359 notes that these issues were raised in a joint response made by the Taxation Institute of Australia, CPA Australia, Farmer's Federation and Council of Small Business Organisations of Australia.

³⁸ Explanatory Memorandum, *New Business Tax System (Simplified Tax System) Act 2000* para 1.6 though asserted: 'Consistent with the Government's approach to business tax reform, the detailed design of the STS has benefited from extensive consultation with business representatives and professional bodies.'

³⁹ The major difference replacement with the 'less than 5% leasing income' criterion (See the *Review's* recommendation 17.1) with exclusions for leased assets from the STS capital allowances regime. Another requirement was added with the \$3 million depreciating assets limit in the former s 328-365(1)(c). Some minor modifications were made to the capital allowances recommendations.

Div 328 ITAA 1997 and s 82KZM ITAA 1936. As discussed later, it was only after the introduction of the STS and some years of experience with its difficulties that the federal Government finally moved to amend the STS and incorporate many of these suggestions.

In implementing the STS there appears to have been some uncertainty as to the federal Government's policy goals.⁴⁰ In the STS Explanatory Memorandum the federal Government provided a rationale of simplification of record keeping and reporting for the small business sector.⁴¹ However, the Explanatory Memorandum⁴² and s 328-50(1) ITAA 1997 both provided a secondary rationale for the STS concessions, asserting that these provisions would reduce the effective tax burden for small business by reducing their tax. Thus the STS appeared to have had two policy goals.

The federal Government had in mind STS concessions that would appeal to most small businesses given that '95% of all businesses' would be eligible.⁴³ However, this 95 per cent figure was grossly exaggerated since only 27 per cent of small business joined the STS.⁴⁴ Consequently, it is evident that the primary STS policy goal of simplification for the small business sector was not achieved given the unpopularity of the STS concessions. The secondary goal of reducing taxation for small business would be similarly unattainable given the low number of adoptions by small business.

2.1 Eligibility Criteria

Under the STS, a small business firstly needed to work out on annual basis whether they were eligible to join or to remain in the STS. Given the complexity of the eligibility rules this initial step may in itself have deterred many small businesses from joining. Such complexity is a structural problem in a 'simplified' system for small business. It is further evident from examining the details of the eligibility criteria that Div 328 failed to provide an appropriate universal definition of a 'small business'. For example, the STS definition of a small business was different from that utilised by the GST,⁴⁵ capital gains tax⁴⁶ and fringe benefits tax⁴⁷ concessions for small business. This is also a major structural problem given the obvious purpose of the STS to 'simplify' compliance costs for small business rather than adding more

For example, depreciating assets with an effective life of 25 years or were to be dealt with by the general capital allowances provisions in Div 40 (recommendation 17.3(iii)). This was changed to include these assets in an STS long life pool with a 5% depreciation rate.

⁴⁰ McKerchar above n 2, 140-141.

⁴¹ Explanatory Memorandum, *New Business Tax System (Simplified Tax System) Act 2000* paras 1.5-1.7.

⁴² Ibid para 1.7.

⁴³ Ibid para 1.5.

⁴⁴ Senate Estimates Committee Hearing <http://www.aph.gov.au/hansard/senate/commtee/S9099.pdf>, 72: Advice from Australian Taxation Office Deputy Commissioner Mark Konza.

⁴⁵ Div 188 A *New Tax System (Goods and Services) Tax Act 1999* (GSTA 1999) in relation to the small business cash accounting concession.

⁴⁶ Subdiv 152-A ITAA 1997, in relation to the small business CGT concession.

⁴⁷ s 58GA *Fringe Benefits Tax Assessment Act 1986* (FBTA 1986) in relation to the small business car parking fringe benefit concession.

layers of law. This was also out of step with the *Review's* aim of an integrated tax code having 'a common dictionary to ensure consistency and greater standardisation of concepts across the Code'.⁴⁸

Under the first eligibility requirement the taxpayer must have carried on a business during the year to enter the STS,⁴⁹ thus passive investors were excluded. However, there is no definitive approach as to what constitutes a business. Rather, the determination of a business is the result of a process of weighing up of a number of relevant factors.⁵⁰ This approach creates great difficulty for taxpayers with small hobby type activities that have some elements of business and lifestyle characteristics. Consequently the vagueness of this definition has resulted in a plethora of cases⁵¹ on business activity and a number of taxation rulings from the Australian Taxation Office.⁵²

The second requirement stipulated that the year's STS average turnover of an STS taxpayer and its grouped entities must have been less than \$1,000,000 net of GST credits and decreasing adjustments.⁵³ This requirement contained grouping rules that prevented large businesses from splitting or restructuring into numerous entities so they were eligible to join the STS.⁵⁴ As commentators noted these grouping rules were extremely complex for small business.⁵⁵

Thirdly, the total adjustable values⁵⁶ of depreciating assets⁵⁷ held at year end by the STS taxpayer and its grouped entities must have been less than \$3,000,000.⁵⁸ The limit on the total value of depreciating assets that an entity and its grouped entities could have at the end of an income year ensured that large entities with low turnovers in early years of operation but with large investments in capital assets were not eligible to enter the STS.⁵⁹

2.2 The Four STS Concessions

The former STS originally comprised of a package of four elements involving: accounting methods,⁶⁰ prepaid expenses,⁶¹ capital allowances⁶² and trading stock.⁶³

⁴⁸ *A Tax System Redesigned* above n 7, 129.

⁴⁹ Former s 328-365(1)(a) ITAA 1997.

⁵⁰ *Evans v FCT* (1989) 20 ATR 922; 89 ATC 4540; AAT CASE 12,860 *Re DAFF and FCT* (1998) 39 ATR 1042.

⁵¹ *Martin v FCT* (1953) 90 CLR 470; *Ferguson v FCT* 79 ATC 4261; *FCT v Walker* 85 ATC 4179; *FCT v Stone* 2005 ATC 4234; *Puzey v FCT* [2002] FCA 1171, 50 ATR 595; *FCT v Sleight* [2004] FCAFC 94, 55 ATR 555.

⁵² Australian Taxation Office, Taxation Ruling (herein after referred to as TR) TR 97/11 'Income tax: Am I carrying on a Business of Primary Production?' www.ato.gov.au; TR 2005/1 'Income tax: carrying on business as a professional artist'; TR 2003/4 'Income Tax: Boat hire arrangements'.

⁵³ Former s 328-365(1)(b).

⁵⁴ Explanatory Memorandum *New Business Tax System (Simplified Tax System) Act 2000* para 1.7.

⁵⁵ Hodgson above n 2, 133; Douglas above n 2, 10; Hine above n 2, 29; Snook above n 2, 75; Bondfield above n 2, 323; Kenny 'A Simplified Tax System for Small Business' above n 2, 39; Tretolla above n 2, 4; McKerchar above n 2, 141-142.

⁵⁶ s 40-85.

⁵⁷ s 40-30.

⁵⁸ Former s 328-365(1)(c).

⁵⁹ Explanatory Memorandum *New Business Tax System (Simplified Tax System) Act 2000* para 2.7.

⁶⁰ Former subdiv 328-C. Note that taxpayers who joined the STS prior to 30 June 2005 can still use the cash accounting system.

The former subdiv 328-C provided a mandatory unique 'cash basis' style accounting method for small business income and expenses which commenced on 1 July 2001.⁶⁴ However, STS cash accounting only benefited certain types of small businesses⁶⁵ that obtained a small timing benefit from the deferral of income tax. Such cash accounting was contrary to accounting practices that required accruals based accounting.⁶⁶ This meant that taxpayers would have needed to incur extra costs to adjust their accounting records. The STS cash accounting rules were both unfair⁶⁷ and inefficient⁶⁸ as they greatly favoured certain types of small businesses.⁶⁹

Under the STS rules the former 13 month prepayment rule for small business⁷⁰ was replaced by a somewhat similar 12 month prepayment rule for STS taxpayers for income years commencing after 30 June 2001.⁷¹ Thus prepayments were immediately deductible for STS taxpayers where the period of the benefit of the prepayment was 12 months for less.⁷² Where the prepayments did not meet this requirement s 82KZM applied to pro rata deductions over the lesser of eligible service period or 10 years. STS taxpayers obtained a small timing benefit from the deferral of income tax provided by the prepayment rules. However, this prepayment rule is also contrary to accounting practices where such prepaid expenses should have been accrued over the period in which the income that was directly related to those expenses was earned.⁷³ Again, this may have increased compliance costs as taxpayers would have needed to adjust their accounting records.

STS taxpayers were generally required to calculate deductions for depreciating assets in accordance with the rules in subdiv 328-D.⁷⁴ Under the STS, depreciating assets were depreciated at accelerated depreciation rates by using a pool as a single depreciating asset.⁷⁵ There were two types of pools. A general STS pool for depreciating assets with an effective life of less than 25 years⁷⁶ and a long life STS

⁶¹ s 82KZM ITAA 1936.

⁶² Subdiv 328-D ITAA 1997.

⁶³ Subdiv 328-E.

⁶⁴ The cash accounting method was abolished prior to the advent of the SBE regime on 30 June 2005.

⁶⁵ In particular the agriculture, forestry, fishing, mining, manufacturing, electricity, gas and water supply, construction, communication, transport and storage and wholesale trade sectors benefit from the STS / SBE accelerated depreciation concessions. The losers included taxpayers involved in the retail trade, accommodation, cafes, restaurants, finance and insurance, property and business services, education, health and community services, cultural and recreational services, sports and personal services businesses.

⁶⁶ Hogettt above n 18, 130; AASB *Framework* above n 18, para 94, 95.

⁶⁷ Kenny 'A Simplified Tax System for Small Business' above n 2, 40-41.

⁶⁸ Martin above n 2, 251; Snook above n 2, 89-90.

⁶⁹ For example, grape growers that were paid in three instalments over April, July and September would defer income on a cash basis. Builders, professional firms and manufacturers were likely to be in the same situation. However, taxpayers with large amounts of creditors compared to debtors would have incurred a cash flow problem, when they entered the STS since deductions for unpaid creditors were generally excluded. Many retailers would have fitted into this situation.

⁷⁰ Former s 82KZM(1) ITAA 1936.

⁷¹ s 82KZM(1)(aa). Note that individuals incurring non business expenditure were also benefited by this rule.

⁷² Ibid.

⁷³ Hogettt above n 18, 130; AASB *Framework* above n 18, para 94, 95.

⁷⁴ s 328-175(1) ITAA 1997.

⁷⁵ s 328-185(1).

⁷⁶ s 328-185(2)(a).

pool for depreciating assets with an effective life of 25 years or more.⁷⁷ An immediate write-off applied to depreciating assets costing less than \$1,000⁷⁸ The STS accelerated depreciation rates were both unfair⁷⁹ and inefficient⁸⁰ as they greatly favoured capital intensive small business.⁸¹

The federal Government asserted that the STS capital allowance provisions ‘will result in compliance cost savings by removing much of the need to maintain individual asset schedules and perform separate calculations for each asset for deduction and balancing charge purposes’.⁸² However, there are a number of reasons why such compliance savings may have been negligible. Firstly, the inflexibility and complexity of the STS needed to be taken into account. Further, the widespread use of computer software packages to calculate depreciation under the non-STS depreciation regime (Div 40) would have produced few difficulties to update depreciation calculations. Given that many small businesses are likely to own relatively few depreciating assets any compliance savings from the STS would have been small. Additionally, the STS treatment is contrary to accounting practices where depreciable assets are required to be amortised over the period in which the income that is directly related to those assets is earned.⁸³ This means small business will have to prepare two sets of accounts, for taxation and financial accounting purposes.

Under the STS trading stock regime, where the difference between the value of the trading stock on hand at the start of an income year and the reasonably estimated value at the end of the year was less than \$5,000 an STS taxpayer did not have to value each item of trading stock at year end and account for any changes in the value of trading stock.⁸⁴ If the change in trading stock was greater than \$5,000 the normal trading stock rules applied.⁸⁵ Avoiding a stock take though could have resulted in significant costs for small business as follows. Firstly, there was the difficult problem of working out what constituted a ‘reasonable estimate’ of trading stock in s 328-285(1)(b). Secondly, most small businesses would nevertheless need to carry out a stock take for financial accounting and internal control purposes.⁸⁶ As commentators noted,⁸⁷ the non tax benefits of stock takes exceeded the costs of undertaking stock takes.

⁷⁷ s 328-185(2)(b).

⁷⁸ s 328-180(1).

⁷⁹ Kenny ‘A Simplified Tax System for Small Business’ above n 2, 40-41

⁸⁰ Martin above n 2, 251; Bondfield above n 2, 330; Snook above n 2, 89-90; Wolfers, Miller above n 2, 376; Kenny ‘A Simplified Tax System for Small Business’ above n 2, 40.

⁸¹ In particular the agriculture, forestry, fishing, mining, manufacturing, electricity, gas and water supply, construction, communication, transport and storage and wholesale trade sectors benefit from the STS / SBE accelerated depreciation concessions. The losers included taxpayers involved in the retail trade, accommodation, cafes, restaurants, finance and insurance, property and business services, education, health and community services, cultural and recreational services, sports and personal services businesses.

⁸² Explanatory Memorandum *New Business Tax System (Simplified Tax System) Act 2000* paras 5.6 – 5.8.

⁸³ Hogettt above n 18, 130; AASB *Framework* above n 18, paras 94, 95.

⁸⁴ s 328-285(1).

⁸⁵ s 328-290.

⁸⁶ AASB *Framework* above n 18, paras 22, 92-95, 101; AASB 102, IAS 2 Inventories.

⁸⁷ Hine above n 2, 3-38; Bondfield above n 2, 334; Kenny ‘A Simplified Tax System for Small Business’ above n 2, 41-42; McKerchar above n 2, 144.

2.3 Amendments to the STS

In response to a number of concerns about the STS the federal Government implemented a series of amendments to the STS to make it more attractive to small business. As noted above, the STS cash accounting basis created a number of problems for many small businesses that utilised accruals accounting and / or obtained little benefit from the concessions.⁸⁸ Consequently, the system was abandoned from 1 July 2005.⁸⁹ STS taxpayers that joined before 1 July 2005 though could continue to use the cash accounting basis.⁹⁰ Further, the capital allowance rules in subdiv 328-D did not originally provide for any roll over relief (unlike Div 40) for depreciating assets. To encourage the uptake of the STS⁹¹ optional roll-over relief was provided.⁹² Additionally, new STS concessions were introduced with the STS exemption from the indirect value shifting rules,⁹³ the STS entrepreneurs discount,⁹⁴ and STS limited amendment periods.⁹⁵

3 SMALL BUSINESS ENTITIES

On 12 October 2005 the former Coalition Government established a taskforce chaired by Gary Banks (*Banks Taskforce*) to reduce the regulatory burden on small business.⁹⁶ The *Banks Taskforce's* report *Rethinking Regulation* was provided to the federal Government on 31 January 2006.⁹⁷ The submissions to the *Banks Taskforce* called for a consistent definition of small business.⁹⁸ The *Banks Taskforce* thus found that there was a need to harmonise taxation law definitions and recommended that the definition of a small business be aligned or rationalised.⁹⁹

Consequently, on 1 July 2007, the federal Government renamed and modified the STS in Div 328 as part of the new 'Small Business Entities' (SBE) regime in order to simplify the various small business concessions.¹⁰⁰ Under the SBE rules the former STS depreciation, prepayment and trading stock income tax accounting concessions were retained with some minor modifications. The new SBE definition of a small business was also aligned with a number of other small business concessions.¹⁰¹

⁸⁸ Tretola above n 2, 14; Kenny 'A Simplified Tax System for Small Business' above n 2, 37; Snook above n 2, 77-78; Wolfers Miller above n 2, 376; Douglas above n 2, 11; Bondfield above n 2, 332-334.

⁸⁹ *Tax Laws Amendment (2004 Measures No. 7) Act 2005*, Sch 2.

⁹⁰ s 328-100 *Income Tax Transitional Provisions Act 1997* (ITTPA 1997).

⁹¹ Explanatory Memorandum, *Taxation Laws Amendment Act (No. 2) 2004* No. 20, para 7.5 states 'Roll-over relief is not currently available for reconstitutions of partnerships operating under the STS (i.e. STS partnerships), deterring some taxpayers from joining the STS. This measure will allow optional roll-over relief for STS partnerships subject to certain conditions.'

⁹² The former s 328-240; ss 328-243, 328-245 ITAA 1997.

⁹³ s 727-470.

⁹⁴ Subdiv 61-J.

⁹⁵ s 170(1) ITAA 1936.

⁹⁶ Taskforce on Reducing the Regulatory Burden on Business (Chairman, Gary Banks) *Rethinking Regulation* 31 January 2006, <http://www.regulationtaskforce.gov.au/finalreport/>.

⁹⁷ *Ibid.*

⁹⁸ *Ibid.*

⁹⁹ *Ibid* 169-170, Recommendation 5.43.

¹⁰⁰ *Tax Laws Amendment (Small Business) Act 2007*.

¹⁰¹ Subdiv 328-C ITAA 1997.

The SBE test provides a new measure for determining what constitutes a small business.¹⁰² From 1 July 2007 SBE have the choice to apply any of the SBE concessions since they are no longer compulsory,¹⁰³ unlike most of the former STS concessions.¹⁰⁴ Under the SBE rules there is no need to lodge an election with the Australian Taxation Office to access the concessions.¹⁰⁵ The former \$1 million STS average turnover threshold¹⁰⁶ was replaced with a \$2 million aggregate turnover threshold¹⁰⁷ and the former STS \$3 million depreciating assets test was abolished.¹⁰⁸ The removal of the depreciating asset limit structurally damages the integrity of the SBE definition of a small business. Under this SBE definition large and medium sized businesses (such as mining companies) will constitute SBE during their start up periods when they will satisfy the \$2 million turnover threshold.

The SBE test now applies to the following concessions:¹⁰⁹

- the SBE prepayment rules; ss 82KZM and 82KZMD ITAA 1936;
- the SBE depreciation rules subdiv 328-D;
- the SBE simplified trading stock rules; subdiv 328-E
- CGT 15-year asset exemption subdiv 152-B;
- CGT 50% active asset reduction subdiv 152-C;
- CGT retirement exemption subdiv 152-D;
- CGT roll-over subdiv 152-E;
- Accounting for GST on a cash basis s 29-40 GSTA 1999;
- Annual apportionment of input tax credits for acquisitions and importations that are partly creditable s 131-5 GSTA 1999;
- Paying GST by quarterly instalments s 162-5 GSTA;
- FBT car parking exemption s 58GA of the FBTA 1986;
- PAYG instalments based on GDP-adjusted notional tax s 45-130 of Schedule 1 TAA 1953;
- Standard 2-year period for amending your assessment applies under s 170 ITAA 1936.

Consequential amendments were made to the above provisions to introduce the new term of SBE and to replace all former small business references (such as ‘STS taxpayers’). However, some of the above concessions impose alternative tests to the SBE requirements. This undermines the simplicity benefit that could have been achieved from having a single definition of small business.¹¹⁰ For example, the small business capital gains tax concessions utilise an alternative \$6 million net assets test.¹¹¹ This breaches the *Review*’s recommendation of an integrated tax code having

¹⁰² s 328-110(1).

¹⁰³ s 328-110(1).

¹⁰⁴ Former subdivs 328-C, 328-D ITAA 1997, s82KZM ITAA 1936.

¹⁰⁵ Subdivs 328-D, 328-E ITAA 1997, s82KZM ITAA 1936.

¹⁰⁶ Former s 328-365(1)(b) ITAA 1997.

¹⁰⁷ s 328-110(1)(b).

¹⁰⁸ s 328-110(1).

¹⁰⁹ s 328-10(1).

¹¹⁰ Hodgson above n 2, 140.

¹¹¹ s 152-15.

‘a common dictionary to ensure consistency and greater standardisation of concepts across the Code’.¹¹²

The former STS entry and exit rules in subdivs 328-F and 328-G were repealed as they are unnecessary under the fully optional SBE regime.¹¹³ However, complex transitional rules were introduced to cater for the move from the STS to the SBE regime.¹¹⁴

3.1 Defining SBE

The SBE regime shares similar levels of complexity with STS, with its complex annual eligibility criteria and aggregation rules.¹¹⁵ An entity is a SBE if it carries on a business¹¹⁶ and satisfies the \$2 million aggregated turnover test.¹¹⁷ An entity will satisfy the \$2 million aggregated turnover test if any of the following three requirements are satisfied:¹¹⁸ the entity's aggregated turnover for the previous income year was less than \$2 million;¹¹⁹ the entity's aggregated turnover for the current income year is likely to be less than \$2 million, calculated as at the first day of the income year;¹²⁰ or the entity's actual aggregated turnover for the current income year was less than \$2 million, calculated as at the end of the income year.¹²¹

A few modifications apply to the second and third criteria. The second requirement excludes businesses that had aggregated turnovers of more than \$2 million in each of the two income years before the current year.¹²² SBEs that only satisfy the third requirement are further restricted as they cannot choose the concessions for PAYG instalments,¹²³ GST cash accounting,¹²⁴ annual apportionment of input tax credits,¹²⁵ or GST quarterly instalment concessions.¹²⁶

Aggregated turnover consists of an entity's annual turnover plus the turnover of all other entities that need to be aggregated with it.¹²⁷ Working out aggregated turnover involves calculating an entity's annual turnover, then applying the aggregation rules and finally adding up the aggregated turnover. Aggregated turnover excludes transactions between connected or affiliated entities.¹²⁸ An entity's annual turnover for an income year is generally the total ordinary income that the entity derives in the

¹¹² *A Tax System Redesigned* above n 4, 129.

¹¹³ Explanatory Memorandum *Tax Laws Amendment (Small Business) Act 2007* para 4.33.

¹¹⁴ *Tax Laws Amendment (Small Business) Act 2007* pages 49-56.

¹¹⁵ Hodgson above n 2, 137

¹¹⁶ s 328-110(1)(a).

¹¹⁷ s 328-110(1)(b).

¹¹⁸ s 328-110.

¹¹⁹ s 328-110(1)(b)(i).

¹²⁰ s 328-110(1)(b)(ii), 328-110(2).

¹²¹ s 328-110(4).

¹²² s 328-110(3).

¹²³ s 45-130 of Sched 1 *Taxation Administration Act 1953* (TAA 1953).

¹²⁴ s 29-40 GSTA 1999.

¹²⁵ s 131-5.

¹²⁶ s 162-5.

¹²⁷ s 328-115(1),(2) ITAA 1997. Thus an entity's aggregated turnover will be the same as its annual turnover if no other entities are aggregated.

¹²⁸ s 328-115(3).

income year in the ordinary course of carrying on a business¹²⁹ excluding amounts that relate to GST¹³⁰ and amounts derived from sales of retail fuel.¹³¹ Any ordinary income that an entity derives from any dealing with an associate of the entity is stipulated as the amount of ordinary income the entity would derive from the dealing as if it were at arm's length.¹³²

If a business is carried on for part of the income year only, the entity's annual turnover for the income year must be worked out using a reasonable estimate of what the entity's annual turnover for the income year would be if the entity carried on a business for the whole of the income year.¹³³ Regulations may allow a different calculation of annual turnover for particular entities.¹³⁴

The annual turnover of other entities needs to be aggregated with an entity if it is an affiliate of another entity; or it is connected with another entity.¹³⁵ An individual or company is an affiliate of an entity where that individual or company acts, or could reasonably be expected to act in accordance with the entity's directions or wishes in relation to the affairs of that individual or company's business; or in concert with the entity in relation to the affairs of the individual or company's business.¹³⁶ An individual or a company though is not an affiliate of an entity merely because of the nature of the business relationship the entity and the individual or company shares.¹³⁷ An entity is connected with another entity if one of the entities controls the other entity, or if the two entities are controlled by the same third entity.¹³⁸ The control rules apply firstly to all entities except discretionary trusts.¹³⁹ Further rules apply to discretionary trusts.¹⁴⁰

For entities other than discretionary trusts an entity controls another entity where the first entity or its affiliates, or the first entity and its affiliates between them beneficially own, or have the right to acquire the beneficial ownership of, interests in the other entity that between them give the right to receive at least 40 per cent of any distribution of either income or capital.¹⁴¹ For control of companies an alternative test applies. Where an entity alone or together with affiliates beneficially own, or has the right to acquire beneficial ownership of, interests in the company with at least 40 per cent of the voting power in the company then the entity will control the company.¹⁴²

¹²⁹ s 328-120(1).

¹³⁰ s 328-120(2).

¹³¹ s 328-120(3).

¹³² s 328-120(4): Amounts derived in an income year from any dealings between an entity and an associate that is a relevant entity within the meaning of section 328-115 are not included in the entity's aggregated turnover for that year: see subsection 328-115(3).

¹³³ s 328-120(5).

¹³⁴ s 328-120(6).

¹³⁵ s 328-115(2).

¹³⁶ s 328-130(1).

¹³⁷ s 328-130(2).

¹³⁸ s 328-125(1).

¹³⁹ s 328-125(2).

¹⁴⁰ s 328-125(3).

¹⁴¹ s 328-125(2)(a).

¹⁴² s 328-115(2)(b).

An entity can control a discretionary trust in the following two situations. Firstly, under the 40 per cent ownership test¹⁴³ an entity is taken to control a discretionary trust for an income year if, for any of the four income years before that income year the trustee paid any income or capital of the trust to or for the benefit of the first entity, its affiliates, or the first entity and its affiliates¹⁴⁴ and the amount paid or applied to the entity and/or its affiliates is at least 40 per cent of the total amount of income or capital paid or applied by the trustee for that income year.¹⁴⁵ Secondly, control of a discretionary trust will occur where the trustee of the trust acts, or could reasonably be expected to act, in accordance with the directions or wishes of the entity.¹⁴⁶

An indirect control test also applies to all entities. If an entity (the first entity) directly controls a second entity, and that second entity also controls (whether directly or indirectly) a third entity, the first entity is taken to control the third entity.¹⁴⁷ Special rules may apply where an entity's interest in another entity is at least 40 per cent but less than 50 per cent. In this situation the Commissioner may choose to ignore the interest of that entity in the other entity if the Commissioner determines that a third entity actually controls the other entity.¹⁴⁸ The complexity of the aggregation rules is evident in the 62 paragraphs of explanation provided in the Explanatory Memorandum accompanying these changes.¹⁴⁹

3.2 SBE Income Tax Accounting Concessions

The SBE regime retained the former STS prepayment,¹⁵⁰ capital allowance¹⁵¹ and trading stock¹⁵² concessions. All references to 'STS taxpayers' in these provisions were simply renamed as 'small business entities.'¹⁵³ Also, under SBE the prepayment rules are no longer compulsory for small business.¹⁵⁴

In respect of small business capital allowances all references to 'STS pools' were replaced with 'small business pools'. Under SBE the depreciation rules are no longer compulsory for small business.¹⁵⁵ These rules only apply if an SBE chooses to use the SBE rules for all of its depreciating assets and the SBE started to use or have them installed ready for use for a taxable purpose.¹⁵⁶ However, if an SBE chooses the subdiv 328-D depreciation rules and subsequently chooses not to use subdiv 328-D, then the entity must wait 5 years after opting out to re-enter.¹⁵⁷ If an entity chooses to use subdiv 328-D the entity must retain the small business pools even after the entity

¹⁴³ s 328-125(4).

¹⁴⁴ s 328-125(4)(a).

¹⁴⁵ s 328-125(4)(b).

¹⁴⁶ s 328-125(3).

¹⁴⁷ s 328-125(7).

¹⁴⁸ s 328-125(6).

¹⁴⁹ Explanatory Memorandum *Tax Laws Amendment (Small Business) Act 2007*, paras 1.11 – 1.73.

¹⁵⁰ ss 82KZM, 82KZMA, 82KZMD ITAA 1936.

¹⁵¹ Subdiv 328-D ITAA 1997.

¹⁵² Subdiv 328-E.

¹⁵³ *Tax Laws Amendment (Small Business) Act 2007*, 38-39.

¹⁵⁴ s 82KZM(1)(aa)(i) ITAA 1936.

¹⁵⁵ s 328-175(1) ITAA 1997.

¹⁵⁶ Ibid.

¹⁵⁷ s 328-175(10).

stops being a SBE or chooses not to use subdiv 328-D.¹⁵⁸ The SBE rules provide further optional roll-over relief for depreciating assets allocated to small business pools.¹⁵⁹

3.3 Choice to account for GST on a cash basis

Normally an entity must account for GST on an accruals basis. This requires that the GST payable on a supply made by an entity is attributed to the earlier of, tax period in which: the entity received any consideration for the supply, or an invoice for the supply is issued.¹⁶⁰ Also, the input tax credit which an entity is eligible to claim on an acquisition that it makes is attributed to the earlier of, the tax period in which: the entity provided any consideration for the goods or services, or an invoice for the acquisition is issued.¹⁶¹

However, from 1 July 2007, a SBE can choose the cash basis.¹⁶² Under the cash basis GST is attributed to the tax periods in which consideration is received and input tax credits are attributed to the tax periods in which you provide consideration.¹⁶³

3.4 Annual apportionment of GST input tax credits

For each tax period and entity must calculate the input tax credit, that is, the amount of GST payable on the supply to an entity.¹⁶⁴ For transactions that involve acquisitions that are only partly eligible for credit, an entity must generally estimate for each tax period on a fair and reasonable basis the creditable amount by a process of apportionment.¹⁶⁵ However, SBE can elect to make their apportionments of input tax credits annually.¹⁶⁶

Thus when an acquisition is made during a tax period the full input tax credit can be claimed in that tax period, even though it is not a fully creditable acquisition.¹⁶⁷ The apportionment is deferred until the next annual income tax return is due to be lodged with the Australian Taxation Office.¹⁶⁸

3.5 Choice to pay GST by instalments

Small businesses are generally required to lodge quarterly GST returns (BAS statements).¹⁶⁹ SBE, though, have an instalments option if they satisfy certain conditions.¹⁷⁰ Under this option, their GST returns are lodged annually and instalments of estimated GST are paid quarterly. An annual reconciliation is then

¹⁵⁸ s 328-185(7) see note, s 328-220.

¹⁵⁹ s 328-243(1A).

¹⁶⁰ s 29-5 GSTA 1999.

¹⁶¹ s 29-10.

¹⁶² s 29-40.

¹⁶³ Ibid.

¹⁶⁴ s 11-25.

¹⁶⁵ s 11-30.

¹⁶⁶ s 131-5.

¹⁶⁷ s 131-40.

¹⁶⁸ s 131-55; 131-60.

¹⁶⁹ s 27-5, if the GST turnover is greater than \$20 million monthly returns are required.

¹⁷⁰ Div 151.

made. The instalments are based on the prior year's GST. Although, penalties may apply if the varied instalments are too low.

SBE may opt to use the instalments system if they satisfy the following requirements:¹⁷¹

- the entity is not required to lodge on a monthly basis and has not elected to do so
- the entity has a current lodgment record of at least four months
- the entity has lodged all previous GST returns as required
- the entity is not in a net refund position

3.6 FBT car parking exemption

Fringe benefits tax (FBT) would normally apply to a small business on car parking benefits provided in respect of the employment of their employees. However, for SBE an exemption applies to car parking benefits provided in respect of the employment of an employee if the following requirements are met:¹⁷²

- the car is not parked at a commercial parking station
- the employer is neither a public company nor a subsidiary of a public company on the day on which the benefit is provided
- the employer is not a government body of a state or of a territory

3.7 PAYG instalments based on gross domestic product (GDP) adjusted notional tax

Under the Pay As You Go (PAYG) instalments system¹⁷³ most taxpayers are required to pay a quarterly instalment after the end of the quarter to which it relates based on the income derived during that quarter. The PAYG instalment for quarterly payers is the instalment rate given by the Commissioner (or a rate chosen by the taxpayer) multiplied by the taxpayer's instalment income for the quarter. Instalment income is generally the taxpayer's gross assessable business and investment income. The instalment for annual payers is the Commissioner's instalment rate multiplied by the taxpayer's instalment income for the year.

However, from 2009-10 SBE can have their quarterly instalments based on prior year income with an adjustment for the change in GDP.¹⁷⁴ Although, an entity may be able to pay instalments based on an estimate of the current year's tax liability if this is more accurate. Under this method an entity pays two or four instalments annually. Entities eligible to pay in annual instalments will still be able to have the choice of paying annually.

3.8 CGT Small Business Exemptions

3.8.1 Basic conditions

¹⁷¹ s 162-5.

¹⁷² s 58GA FBTAA.

¹⁷³ Sch 1 Pt 2-10 Div 45 TAA 1953.

¹⁷⁴ s 45-112.

Under Division 152 ITAA 1997 capital gains tax (CGT) exemptions are available to entities if the following conditions are satisfied:¹⁷⁵

- a CGT event happens in relation to a CGT asset of the entity¹⁷⁶
- apart from Div 152, the CGT event would have resulted in a capital gain
- the CGT asset satisfies the active asset test in s 152-35, and
- the entity is a SBE, or it satisfies the \$6 million maximum net asset value test in s 152-15; or the entity is a partner in a partnership that is a SBE for the income year and the CGT asset is an asset of the partnership.

If the CGT asset is a share in a company or an interest in a trust then two further requirements must be met. Just before the CGT event:¹⁷⁷

- the entity claiming the concession is a CGT concession stakeholder in the company or trust under s 152-60, or
- CGT concession stakeholders in the company or trust together have a small business participation percentage in the entity claiming the concession of at least 90%.

Maximum net asset value test

This test is met if, just before the CGT event, the sum of the net value of the CGT assets owned by:¹⁷⁸

- the SBE
- any entities connected with the SBE, and
- any affiliates of the SBE or entities connected with such affiliates,

does not exceed \$6m.¹⁷⁹ Under this test the small business and its related entities are dealt with as one economic entity. For example if the net value of the economic entity's assets is greater than \$6m the small business CGT concessions do not apply.

The net value of the CGT assets of an entity is the sum of the market value of the entity's CGT assets less the following items:¹⁸⁰

- liabilities related to the assets
- provisions for annual leave
- provisions for long service leave
- provisions for unearned income
- provisions for tax liabilities.

A person is a small business CGT affiliate if:¹⁸¹

¹⁷⁵ s 152-10(1) ITAA 1997.

¹⁷⁶ CGT events K7 (deals with capital gains from CGT assets that are depreciating assets: s 104-235) is excepted. Further exclusions in certain circumstances are provided for CGT events J2, J5 and J6 are set out in s 152-10(4).

¹⁷⁷ s 152-10(2).

¹⁷⁸ s 152-15.

¹⁷⁹ See s 152-20 for the net value of the CGT assets; see s 328-25 for when an entity is connected with another entity; see s 328-130 for what constitutes an affiliate.

¹⁸⁰ s 152-20.

- the entity was an individual and the person was the individual's spouse or child under 18 years, or
- the person acted, or could reasonably be expected to act, in accordance with the entity's directions or wishes, or in concert with the entity.

However, a person is not automatically another person's small business CGT affiliate simply as a result of a business relationship. Thus partners, co-directors or co-trustees or partners are not always affiliates.

An entity was connected with another entity if:¹⁸²

- either entity controlled the other, or
- both entities were controlled by the same third entity

For partnership assets, the maximum net asset value test, only includes the assets of each partner and not the assets of the entire partnership.

Active asset test

A CGT asset satisfies the active income test if:¹⁸³

- the taxpayer has owned the asset for 15 years or less and the asset was an active asset of the taxpayer for a total of at least half of the relevant period, or
- the taxpayer has owned the asset for more than 15 years and the asset was an active asset of the taxpayer for a total of at least 7½ years during the relevant period.

Section 154-40(1) provides that a CGT asset is an active asset of a taxpayer at a given time if, at that time:

- the taxpayer owns it and uses it, or holds it ready for use, in the course of carrying on a business; or
- the taxpayer owns it and it is used, or held ready for use, in the course of carrying on a business by the taxpayer's affiliate or another entity connected with the taxpayer, or
- the taxpayer owns it and if it is an intangible asset, it is inherently connected with a business carried on by the taxpayer, an affiliate or another entity connected with the taxpayer (for example goodwill, or the benefit of a restrictive covenant).

CGT assets that cannot be active assets

The following CGT assets cannot be active assets per 152-40(4):

- (a) interests in an entity that is *connected with you, other than *shares and interests covered by subsection (3);

¹⁸¹ s 328-130.

¹⁸² s 328-125.

¹⁸³ s 152-35(1).

- (b) shares in a company, other than:
 - (i) shares in a *widely held company that are covered by subsection (3), (3A) or (3B) and held by a *CGT concession stakeholder of the company; and
 - (ii) shares in any other company that are covered by subsection (3), (3A) or (3B);
- (c) interests in a trust, other than:
 - (i) interests in a trust to which subsection (5) applies that are covered by subsection (3), (3A) or (3B) and held by a CGT concession stakeholder of the trust; and
 - (ii) interests in any other trust that are covered by subsection (3), (3A) or (3B);
- (d) financial instruments (such as loans, debentures, bonds, promissory notes, futures contracts, forward contracts, currency swap contracts and a right or option in respect of a share, security, loan or contract);
- (e) an asset whose main use in the course of carrying on the *business mentioned in subsection (1) is to *derive interest, an annuity, rent, royalties or foreign exchange gains unless:
 - (i) the asset is an intangible asset and has been substantially developed, altered or improved by you so that its *market value has been substantially enhanced; or
 - (ii) its main use for deriving rent was only temporary.

Under s 152-42 a trustee of a discretionary trust may nominate not more than four beneficiaries as being controllers of the trust for an income year for which the trustee did not make a distribution of income or capital if the trust had a tax loss, or no taxable income, for that year (s 152-42(2)). This means that each nominated beneficiary controlled the trust for that income year as required per s 328-125. Thus these nominated beneficiaries are connected with the trust.

Section 152-45 alters the active asset test in s 152-35 if there is an involuntary disposal of an asset. In this situation, the active asset test requires that the asset owned must have been an active asset during at least half of a specified period.

Significant individual test

Section 152-50 provides a significant individual test for CGT events that occur after 30 June 2006. Under s 152-10(2) for an entity is entitled to relief under Div 152, a significant individual must be a CGT concession stakeholder of the company or trust under s 152-60. An entity meets the significant individual test if the entity had at least one significant individual just before the CGT event.

Under s 152-55, an individual is a significant individual in a company or a trust at a time if, at that time, the individual has a small business participation percentage in the company or trust of at least 20%. Thus up to eight taxpayers can obtain the Div 152 concessions, ie taxpayers and their spouses.

CGT concession stakeholder

An individual is a CGT concession stakeholder of a company or trust at a time if the individual is per s 152-60:

- a significant individual in the company or trust; or
- a spouse of a significant individual in the company or trust, if the spouse has a small business participation percentage in the company or trust at that time that is greater than zero.

Small business participation percentage in another entity at a time is the sum of the entity's, s152-65:

- direct small business participation percentage in the other entity at that time
- indirect small business participation percentage in the other entity at that time

Direct small business participation percentage

An entity's direct small business participation percentage in a company is the percentage that the entity has because of holding the legal and equitable interests in shares in the company, s152-70:

- (a) the percentage of the voting power in the company
- (b) the percentage of any dividend that the company may pay
- (c) the percentage of any distribution of capital that the company may make.

If these amounts are different, use the smaller or smallest amount. Note that redeemable shares are ignored per s 152-70(2).

For trusts, two situations apply. First, if the entities have entitlements to all the income and capital of the trust then an entity's direct small business participation percentage is the percentage of any distribution of income or of capital that the trustee may make to which the entity would be beneficially entitled. If these amounts are different, use the smaller amount.

Secondly, if the entities do not have entitlements to all the income and capital of the trust then an entity's direct small business participation percentage in a trust is the percentage of the distributions of income or of capital made by the trustee to which the entity was beneficially entitled. If these amounts are different, use the smaller or amount. Where the trust did not make a distribution of income or capital during the year, then there will be no significant individual during that year.

Indirect small business participation percentage

To calculate the indirect small business participation percentage, first, it is necessary to calculate the direct small business participation percentage that the entity (known as the holding entity) has in another entity (known as the intermediate entity) at that time.¹⁸⁴

Second, multiply the above amount by the sum of:¹⁸⁵

¹⁸⁴ ss 152-75(1)(a), 152-70.

¹⁸⁵ s 152-75(1)(b).

- (i) the intermediate entity's direct small business participation percentage (if any) in the test entity at that time, and
- (ii) the intermediate entity's indirect small business participation percentage (if any) in the test entity at that time (as worked out under one or more other applications of this section).

If there is more than one intermediate entity to which paragraph (1)(a) applies at that time, the holding entity's indirect small business participation percentage is the sum of the percentages worked out under subsection (1) in relation to each of those intermediate entities.¹⁸⁶

Under s 152-80, access to the small business concessions can still be obtained within two years of the death of an individual. In this situation the relief is obtained by the deceased person's legal personal representative or beneficiary.

3.8.2 15 year exemption, Subdiv 152-B ITAA 1997

A small business entity can disregard a capital gain arising from a CGT asset where it owned the CGT asset for at least 15 years. To gain this exemption the following requirements must be met:

- the basic conditions for relief in Subdiv 152-A are satisfied
- the entity continuously owned the asset for the 15-year period leading up to the CGT event
- if the entity is an individual, he or she is over 55 years of age and retires, or is permanently incapacitated, and
- if the entity is a company or trust, it had a significant individual for a total of at least 15 years during which the entity owned the asset and the individual who was the significant individual just before the CGT event retires or is permanently incapacitated.

Further time extensions apply for subdiv 152-B if there is roll-over due to marriage breakdown or compulsory acquisition, s152-115.

3.8.3 50% Reduction, Subdiv 152-C

Under s 152-205 the amount of a capital gain remaining after applying Step 3 in the method statement in s 102-5(1), is reduced by 50% if the basic conditions (subdiv 152-A) are met in respect of the gain. However, the 50% reduction does not apply where the 15-year exemption applies, s 152-215. Section 152-220 allows an entity to choose not to use the 50% reduction amount in the capital gain.

The method statement in sec 102-5(1) provides in respect of CGT:

Calculate Capital gain in current year
Deduct current year capital losses
Deduct current year capital losses
Deduct CGT discount
Deduct small business concessions

¹⁸⁶ s 152-75(2).

= Net capital gain

For individuals, since the small business 50% reduction applies after the 50% CGT discount, this results in an effective 75% reduction in the capital gain. A company though can only receive the 50% active asset reduction. Also, an individual that elects indexation will only receive the 50% active asset reduction.

3.8.4 CGT retirement exemption, Subdiv 152-D

An individual can choose to disregard all or part of a capital gain per s 152-305(1), if:

- (a) the basic conditions in Subdiv 152-A are satisfied for the gain
- (b) the individual is under 55 just before making the choice - the individual contributes an amount equal to the asset's CGT exempt amount to a complying superannuation fund or an RSA, and
- (c) the contribution is made at the later of making the choice and receiving the proceeds. However, if the CGT event is CGT event J2, J5 or J6, the contribution must be made when the individual made the choice.

Under this concession, individual aged 55 or over can access a CGT exempt amount and if eligible, can claim a tax deduction for this amount as a personal contribution to superannuation. Such deductible contributions must be included in the concessional contributions cap.

Under 152-305(2), a company or a trust (except a public entity) can choose to disregard such an amount if:

- (a) the basic conditions in Subdivision 152-A are satisfied for the capital gain; and
- (b) the entity satisfies the significant individual test (see section 152-50); and
- (c) the company or trust conditions in section 152-325 are satisfied.

Where an entity makes the choice in s 152-305 for any part of the capital gain from the CGT asset, that part of the capital gain equal to its CGT exempt amount is disregarded.

An individual must ensure that his or her CGT retirement exemption lifetime limit of \$500,000 is not exceeded. A company or trust must also ensure that the CGT retirement exemption limit of individuals is not exceeded. The CGT exempt amount must be set out in writing, s 152-315(4).

Section 152-325 provides further conditions that a company or trust must satisfy before being entitled to choose to apply the small business retirement exemption. The company or trust, as the employer of the CGT concession stakeholders, must make a payment to the CGT concession stakeholders. The payment must be made in the two situations specified in s 152-325(1).

Also, subdiv 152-D does not apply to a capital gain to which the 15-year exemption applies, per 152-330.

3.8.5 CGT roll-over, Subdiv 152-E

Section 152-410 provides that a taxpayer can choose to obtain a small business roll-over if the basic conditions in Subdiv 152-A are satisfied for the capital gain. Roll-over can be applied even where the replacement asset has not yet been acquired, or where the taxpayer has not yet incurred fourth element expenditure to improve the asset. Section 152-415 allows a taxpayer choosing roll-over to elect to disregard all or part of each capital gain to which Subdiv 152-E applies.

CGT event J5 though happens if, by the end of the replacement asset period, the taxpayer has not acquired the asset or incurred the expenditure, s 104-197. Also, CGT event J6 happens if, by the end of the replacement asset period, the cost of the replacement asset or the amount of fourth element expenditure incurred is less than the amount of the capital gain that was disregarded, s 104-198. The replacement asset period commences one year before, and ends two years after, the last CGT event in the income year for which a roll-over was elected.

Where the taxpayer acquired a replacement asset or incurred fourth element expenditure and there is a change in respect of the replacement asset or the improved asset after the end of the replacement asset period, then CGT event J2 may happen, s 104-185. If this happens, the capital gain may be eligible for further roll-over relief under subdiv 152-E.

Special rules apply in s 152-420 if an individual who has obtained a roll-over under Subdiv 152-E dies. Further, subdiv 152-E does not apply to a capital gain to which the 15-year exemption applies, s 152-430.

4 SBE CONCESSIONS: THE NEW PROPOSALS

The new Federal Labor Government has recently proposed adding two more the SBE concessions. These proposals imply that the SBE regime has been accepted by policymakers as the appropriate tax policy framework for assisting small business.

4.1 PAYG 20% Instalment Reduction

The Government proposed a 20 per cent cut in respect of the December 2008 quarter PAYG tax instalment to:¹⁸⁷

‘offer some much-needed relief to around 1.3 million small businesses - many of them doing it tough due to the global financial crisis... It will provide immediate and much-needed cash flow relief to small businesses and encourage small business confidence.’

Under PAYG, a monthly or quarterly income tax instalments for business are based on current trading or income conditions and are paid after the income is earned. This quarterly instalment amount is due on or before 2 March 2009 for most small businesses.¹⁸⁸ For some small businesses that elect pay GST tax on a monthly basis,

¹⁸⁷ Joint Media Release No 140 above n 3.

¹⁸⁸ Ibid.

the due date is 21 January 2009.¹⁸⁹ Thus, under this proposal SBE only have pay 80 per cent of the instalment amount shown on their Business Activity Statement (BAS) on 21 January 2009 or 2 March 2009.

However, the 20 per cent reduction will not apply if SBE calculate their instalments based on the instalment rate notified by the ATO.¹⁹⁰ For these taxpayers, their payments will automatically adjust when they apply the given rate to their actual income for the quarter. The 20 per cent PAYG reduction, though, only provides a temporary timing benefit and generally assists larger sized small businesses that have larger PAYG liabilities.

4.2 Bonus Depreciation

The Government also recently proposed a temporary extra tax depreciation and capital allowance deduction for businesses in accordance with its nation building and jobs plan.¹⁹¹

SBE can claim an additional 30 per cent tax deduction for eligible assets costing \$1,000 or more acquired between 13 December 2008 to 30 June 2009.¹⁹² The assets have to be installed ready for use by 30 June 2010.¹⁹³ For eligible assets costing \$1,000 or more acquired from 1 July 2009 to 31 December 2009, SBE can claim an additional 10 per cent deduction if installed by 31 December 2010.¹⁹⁴ The Treasurer stated that this ‘...will give businesses confidence to continue to plan positively and invest for the future, providing crucial support to growth and jobs during these difficult economic times.’¹⁹⁵

Eligible assets are new tangible depreciating assets and new expenditure on existing assets used in carrying on a business for which a deduction is available under the general depreciation provision, section 40-30 and that qualify for capital allowance under Subdiv 40-B ITAA 1997.¹⁹⁶ Intangibles and rights that would otherwise be included by subss 40-30(2), (5) and (6) are excluded.¹⁹⁷

However, the SBE bonus depreciation proposals only favour a minority of capital intensive small businesses. Also, given the complexity of entering the SBE regime for many taxpayers these measures will have a limited effectiveness in assisting small business.

5 CONCLUSION

The STS was built on a unstable foundation and has been subject to much criticism. Consequently, the former Coalition Government sought to improve the concessions

¹⁸⁹ Ibid.

¹⁹⁰ Ibid.

¹⁹¹ Prime Minister’s media release above n4; Treasurer’s media release 141 above n 4; Joint media release above n 4.

¹⁹² Ibid.

¹⁹³ Ibid.

¹⁹⁴ Treasurer’s Media Release 141 above n 4.

¹⁹⁵ Ibid.

¹⁹⁶ Ibid.

¹⁹⁷ Ibid.

for small business by replacing the STS with a SBE regime that streamlined the definition of a small business and by making the SBE concessions fully optional. These changes were steps in the right direction towards simplification. The recent Labor Government proposals to extend the concessions for SBE suggesting its acceptance of the SBE framework.

However, the SBE regime does not address the underlying structural problems in the STS. The new rules fail to provide an appropriate universal definition of a 'small business'. The various small business taxation concessions still have a number of additional or alternative requirements that negate the benefit of the SBE definition. This breaches the *Review's* recommendation of an integrated tax code having a common dictionary. Further, the removal of the \$3 million depreciating asset limit damages the integrity of the SBE definition of a small business since larger capital intensive businesses will constitute SBE during their start up periods when they will satisfy the \$2 million turnover threshold. The question of what constitutes a small business still remains to be answered. The taxation laws need an appropriate and universal definition of small business. If the purpose of the relief is to compensate for the regressive impact of compliance costs on small business, then these costs should be established for the different types of small business.

Additionally, the SBE regime faces similar complexity issues to the STS, with its complex annual eligibility criteria such as the aggregation rules. The SBE depreciation, prepayment and trading stock concessions share the same complex technical issues as the former STS provisions.

Further, like the former STS concessions, the new SBE bonus depreciation proposals only favour a minority of capital intensive small businesses. The 20 per cent PAYG reduction generally helps the larger sized small businesses that have larger PAYG liabilities and only provides a temporary timing benefit. Overall, given the limited benefits, poor targeting of small business and the inherent complexity of the SBE concessions, it is submitted that these concessions do not appear to offset the onerous income tax compliance costs for small business.

The current *Henry Review* provides a timely opportunity to address the fundamental issues of: adequately and simply defining a small business; providing a sound rationale for small business tax concessions; and effectively targeting help to small businesses in most need of assistance. Another possibility, is replacing the SBE tax concessions with direct compensation to small business as a simpler and more transparent means of addressing the regressive compliance costs of small business.